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**ECONOMIC RECONSTRUCTION  
IN SOUTH EAST EUROPE**

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## ECONOMIC RECONSTRUCTION IN SOUTH EAST EUROPE

by Daniel Daianu<sup>1</sup>

South East Europe is marked, in this decade, by several major military conflicts which involved the constituents parts of the former Yugoslavia. The wars in the region caused enormous pain, suffering, and entailed the deaths of hundreds of thousands of people; there has been also enormous destruction, with the latest war causing immense damage to the civilian infrastructure of Kosovo and Serbia. These conflicts are inextricably linked with the dissolution of the former Yugoslavia (the formation of new sovereign states), against the background of the collapse of communism in Europe and resurgent nationalism, religious and ethnic identity.

In the aftermath of the last major conflict, in Kosovo (Yugoslavia), the state of affairs in the Balkans is not less unclear at all. On the contrary, one could claim that major uncertainties about future dynamics persist; that the political map of the region is “still in motion”, the state of economies has worsened, reform policies may stumble, and societies are less stable.

### **Analogies with the end of the second world war can be misleading**

Some pundits are tempted to make an analogy with the end of the second world war in evaluating the prospects of the region. Even proposing a new Marshall Plan sources part of its justification in such an analogy. But, arguably, one should rather be cautious in making such a comparison, in over-stretching the relevance of history. Firstly, at that time there was no process of state-formation (state dissolution) and, thence, no ensuing conflicts; this fact favored, in a few years time, the start of the process of economic integration by the setting up of the Coal and Steel European Communities. Secondly, there was a clear distinction between victor and loser in the war, which did not involve revision of borders.<sup>2</sup> This is not the case in the Balkans nowadays, where borders are still questioned, more or less loudly. Thirdly, the Marshall Plan meant, primarily, an infusion of funds for energizing economic reconstruction in an area which did possess the institutional ingredients of a market economy. Fourthly, there was, at that time, a big common enemy: communism, external and internal (with the latter represented by the strength of the communist parties in Italy and France). Who is the big common enemy of the peoples in the Balkans, at the end of this century? A candidate would be poverty, underdevelopment in a prosperous Europe. But this is an imprecise enemy and not easy to deal with by looking at worldwide experience. The observations made above are not meant to downsize the importance of aid for the Balkans. On the contrary, this author believes that assistance is badly needed, but it should be wisely calibrated and provided.

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<sup>2</sup> Certainly, the division of Germany could be mentioned as a counterexample, but it does not change the thrust of the assertion.

This aid needs to take into account the complexity of intra-regional relations, the still murky political geography of the area, the existence of latent conflicts, etc.

This extremely complex situation links inextricably national economic objectives (including economic security) with other goals, such as peace and security. At the same time, the stability of the region as a whole can be viewed as a collective good, a public good for Europe. From such a perspective Europeans have a stake in helping the people in the Balkans ridding themselves of the demons of the past and the present. The Stability Pact seems to be an embodiment of this *prise de conscience* which needs to be followed by concrete deeds.

Nonetheless, whereas goals can be easy to define in abstract terms (peace and security, social cohesion, economic progress, “market-oriented reforms”, etc) they are much harder to formulate and pursue practically –particularly when they imply hardly reconcilable objectives of non-cooperating governments, or have to be pursued under very adverse circumstances. In the Balkans this situation is ubiquitous and explains the heavy presence of outsiders, the existence of protectorates. But foreign presence does not simplify the solution to problems automatically.

### **A new policy**

Tackling the problems of South East Europe requires a vision which should frame the policies of both domestic (local governments) and external actors. This new vision and policy needs to consider: **A.** the consequences of the years of immense destruction brought about by military conflicts; **B.** the failures of reform efforts; **C.** and the still very complicated nature of relations inside the region –all these in conjunction with a development challenge. In this respect policy-makers need to take into account lessons of development experience such as:

- the importance of economic stability for growth;
- growth trickles down too slowly, so development efforts must address human needs directly;
- development needs a comprehensive approach;
- sustained development must be socially inclusive.<sup>3</sup>

The new policy needs to consider what is realistic to achieve without shunning bold action; it also needs to put the whole endeavor into a longer term timeframe, keeping in mind the intricacies of the situation on the ground. I would say that policy-makers should cast their endeavors under three major headings:

- crisis-management;
- economic reconstruction;
- and the change of the regime of functioning of economies (institutional change).

In this respect it can be said that dealing with South East Europe needs to be judged from two inter-related perspectives. One is the exercise in dual (short- and long-term) crisis-management, which aims, *inter alia*, at arresting (reversing where it is possible) bad path-

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<sup>3</sup> 1998 World Bank Development Report. See also Shahid Yussuf, “Development challenge: think globally but act locally”, International Herald Tribune, 17 September, 1999

dependencies. The second perspective concerns reconstruction, which would have to be a two-pronged strategic endeavor: physical reconstruction (after the years of military ravages); and development (modernization), that includes institutional change ( market-oriented reforms) and the political process.

### **The need for crisis-management**

The termination of the last military conflict does not rid South East Europe (the Balkans) of its deep-seated, latent animosities and other sources of conflict (of future conflicts) Therefore it makes sense to talk about crisis-management in a dual temporary perspective *cum* economic assistance.

Crisis-management has to be seen over the short-term and the longer term. Over the short term it refers to mitigating the losses and the pains related to the recent military conflict, or avoiding new bloody clashes.

However, it can be submitted that *crisis-management* in this region is of a different sort, in the sense of having to be projected long-term as well; it has to be an exercise linked with the nature of conflicts among the local players. It may take years and years, if not decades for injuries to heal. It may require the presence of “outsiders” for a long period of time. Crisis-management over the longer term should be in the service of achieving peace and security in the Balkans.

### **Working assumptions for crisis management**

Several assumptions can be submitted with regard to crisis management:

- unless the region gains a certain amount of stability and mutual tolerance among the local players, it would be hard to embark on region-wide reconstruction;
- mutual tolerance would involve changes in collective psychology; This is why the talk of introducing a single currency and of creating a free trade area in the region (the CEPS study) may sound attractive but may be divorced from reality as an immediate prospect for policy action;
- crisis-management needs to be more prevention- than reaction-oriented; to this end there is need for a better understanding of the roots of collective psychology in the region;
- crisis-management and conflict resolution involves a tremendous effort for confidence-building (injury-healing), which would be well addressed by restoring economic ties among the local players; this means strenuous efforts at developing economic cooperation in the region, among the former components of the old Yugoslavia;
- crisis-management does not exclude starting economic reconstruction;
- crisis-management has to consider the extreme institutional frailty of the countries in the region and their heightened vulnerability to both domestic and external shocks; In this respect much attention needs to be paid to the state of the banking systems.
- Crisis management should consider both common features and diversity in South East Europe

## Economic reconstruction

Several assumptions regarding economic reconstruction are submitted below. Thus:

- clear prospects of economic reconstruction (in both physical and institutional sense) would give the people in the region hopes and, particularly, incentives to think less about the past and more about a better future;
- there is need for considerable and creative aid (from outside), in the vein of a Grand Plan, on the basis of close policy coordination among the donors.
  - the Plan should include major infrastructure projects, of regional importance, which would hook up South East Europe with the European Union; the positive spillover effects would be enormous. The European Investment Bank and the World Bank have a major role to play in this field.
- Public works would help deal with the plight of enormous unemployment in some of the countries; it will provide lots of people jobs in the official economy and help combat crime. In the same vein should be judged the stimulus given to construction industry in the areas which suffered big destruction due to the wars.
- South East Europe needs soft loans, both for major infrastructure projects as well as for helping small and medium sized enterprises (the private sector);
- outside financial assistance should be linked with positive discrimination in favor of local companies –this would help deal with sizeable unemployment;
- because of the way the region is perceived by investors official creditors will play a major role for years to come;
  - it is essential that Serbia be part of the process of reconstruction; it is a key country in the region, with a strategic location, and its infrastructure needs to be rebuilt; isolating Serbia would not necessarily enhance democracy in that country, it may even prove counter-productive<sup>4</sup>. The venues for not isolating Serbia would be two:
    - a/ defining humanitarian aid in a broad sense, which should involve restoration of power generation and heating facilities;
    - b/ considering bridges and Danube, the river, as collective goods), which fall under the jurisdiction and the use of several countries.
- Bulgaria and Romania should be covered by such a plan. Both countries can operate as in-built political stabilizers, but are themselves in need of economic support.
  - the Plan should consider more forceful measures for dealing with various social and institutional evils which plague the region ( drug-trafficking, arms-smuggling, etc). This would be also part of the long-term exercise in crisis-management (confidence-building).

## Providing assistance

The assistance to the region can be conceived from several angles which are sketched underneath

A/ the nature of aid, which can be seen as:

- immediate humanitarian aid;
- macroeconomic support for the sake of dealing with balance of payments gaps, budget deficits, labor dislocation impact, trade disruption and loss of markets (the kind of effects identified by the IMF/WB study);

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<sup>4</sup> Carl Bild, International Herald Tribune, 29 August 1999. See also Quentin Peel's article "Perilous Policy", Financial Times, 12 August, 1999, p.10

- infrastructure projects for the short term such as pontoon bridges to be built over the Danube, and water supplies facilities in Albania;
  - advancing market-oriented reforms (privatization and corporate governance, build up of legal and enforcement frameworks, etc)
  - the strengthening of local banks;
- B/ Time horizon. Over the longer term aid needs to cover infrastructure development, institutional build-up (including governance capabilities).
- C/ policy coordination involving region-wide and country specific programs. This policy coordination needs to be effective; to this end it needs to be done by someone, presumably by the EU, which is called upon to devise a strategy for South East Europe. The Agency for Reconstruction (with the siege in Thessaloniki) would have to become instrumental to this end.
- policy coordination has to translate into actions which empower the policy-making and governance capabilities of the national governments;
  - economic assistance should not be devoid of conditionality, but it should be part of national economic programs. Policy coordination needs to consider the various tasks which can be fulfilled by the IFIs.

### **Economic regime change (market-oriented reforms)**

It could be argued that when “being with the back against the wall” and, consequently, not having presumably any other choice, the way forward is clearly cut. But, in real life, there are always options and, often, it is not so clear which the best means for advancing market reforms are. The bottom line, however, is that policy-makers, presumably, have a vested interest in making their economies perform better; this would imply imposing harder budget constraints (financial discipline), fiscal rectitude, restructuring of enterprises, strengthening the banking systems, enforcing legality, etc. The biggest hurdles for governments are the adverse conditions represented by the size of unemployment in most of the economies, the negative growth rates, and the way institutions do function –which impinges on the formulation and implementation of economic policy.

There are two tracks for considering the enhancement of market reforms in the region. One regards the national policies of governments which are supposed to carry out reforms. Assistance from outside (from the IFIs and the EU) is also geared towards enhancing reforms. There is another track, which is linked with the institutions of cooperation that can foster reforms. Such can be agreements (new rules) which enhance trade in the region, or contractual arrangements with the EU. The intention of the latter to establish *stabilization and association arrangements* (SAA) with several countries of the region is a step in that direction.

But institutional change can be conceived in the framework of grandiose schemes, which would, arguably, uplift all economies. A grandiose scheme is propounded, for instance, by the Center for Economic Policy Studies (CEPS) of Brussels.<sup>5</sup> This master plan projects a “way out of the woods” for the region within the overall framework of European integration. Actually, this is, probably, the biggest attraction of this master plan, in the

<sup>5</sup> See also Daniel Gros, “Euro statt Rubel” (The Euro instead the Ruble), *Die Zeit*, 22 May, 1999

sense of stating unequivocally the ultimate objective of admission of the region into the EU. And for that purpose a campaign is propounded which involves more than substantial aid (about 5 billion EURO per year). A main feature and novelty of the Plan is that, though not so explicitly said in plain words, it demands a de facto and de jure institutional rapprochement (coalescence) of the economies of the Balkans.; common institutions in the region are seen as instruments for integration into the EU. There is thus talk about generalizing currency boards and introducing a single currency (the EURO) in a few years time, the creation of a free trade area in the region and its linkage with the EU via a similar mechanism, the management of border customs by officials from the EU, etc. One could even say that this plan envisages the creation of a quasi-union of South East Europe. Strikingly, the dynamics suggested by the CEPS plan would have to occur in a region which is still subject to intense fragmentation and major conflicts –whether latent or open. There are merits in the CEPS plan, primarily the projection of integration into the EU as the ultimate goal and the promotion of cooperation in the region. Nonetheless, there seems to be also a heavy dose of overshooting the reality on the ground. This excessive optimism should be judged as against the low propensity of countries to cooperate region-wide; with the considerable lack of complementarity of economies (which have, more or less, similar structures of exports and need to import capital goods from the West), although intra-regionally trade can obviously expand; with the danger of being exposed to soon to competition from EU exporters, etc.

The Stability Pact, itself, implies a vision and a master plan for dealing with the whole region. The three baskets (security, economy, democratization) convey the image of a bold and comprehensive regional approach. But this plan still needs to be fleshed out and the economic component needs to be supplemented by an elaborate agenda of action and actual financial support for the whole region, over an adequate period of time. This plan would have to embrace the operations of the official creditors (donors), with a view of securing effective coordination of assistance and maximum performance.

### **Hindrances for and threats to reconstruction**

Reforms and reconstruction in the South East Europe have to cope with hindrances of domestic nature and developments outside the area.

Among the main domestic barriers I would reiterate:

- weak institutions, weak states, which have a very low capacity to formulate and carry out reforms. This institutional poverty should be judged in relation with the capacity of the state to mobilize resources for development.<sup>6</sup>
- meager resources and very strained budgets;
- aid-addiction;
- the size of informal sectors and the extent of criminalization of economy;
- absorption of resources by non-economic goals;

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<sup>6</sup> Weak states can also be seen as states with low legitimacy. It is noteworthy that the latter can be detected in both states with high ethnic homogeneity (Albania) and where there is, supposedly, “multi-ethnicity” (Bosnia-Herzegovina).

- low propensity for regional cooperation when the political geography of the area is still to be defined<sup>7</sup>, and when there is genuine fear that neighbors may “export” their networks of organized crime.

External threats to reconstruction need to be judged in conjunction with the current Zeitgeist vis-à-vis South East Europe, that there is need for serious, long-term commitment to help the region get out of its doldrums. Would the current mood persist in view of the proliferation of crises, whether in Europe or elsewhere. Would the span of attention turn into a long-lasting commitment? These are justified questions considering some signs such as:

- the unambiguous indication by Washington that it wishes the EU to foot the bill of the reconstruction of the region;
- the World Bank’s message that it wants to keep a low profile by assuming that the EU will be the main actor and coordinator;<sup>8</sup>
- Brussels has not yet formulated a plan for dealing with South East Europe, aside from the ideas emanating out of the Stability Plan which was put forward by the German government. In order to see how unprepared the EU is in this respect it pays to remind that the Agenda 2000 did not have one single paragraph on the Balkans.
- since the EU does not yet have a long term plan it is fair to assume that there is not yet any solid financial commitment to this purpose.
- western European governments have serious budgetary problems of their own;
- the front-runners for joining the EU have expressed concerns that the current focus on the Balkans may slow down their process of admission; they are also worried that more resources for South East Europe would automatically mean less aid for them.

### **Final remarks**

Challenges for economic reconstruction in South East Europe are enormous and stem from the interplay between the effects of physical destruction and fatigue of millions of people involved in inter-ethnic and military conflicts, and failures of efforts to advance market reforms.

The economies of the region are in a very precarious state; there are important differences among them, but, in the end they all face common difficulties linked with growing macroeconomic imbalances, feeble capital inflows and inability to create prerequisites for growth resumption on a sustained basis. Some of these economies have developed a worrying aid-addiction and are heading toward a dead-end. The institutional set ups are very fragile and, in certain cases, public governance is basically non-existent. In addition, the political geography of South East Europe is still unclear and, in spite of heavy external

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<sup>7</sup> At a recent Halki (Greece) symposium (September 1999) Susan Woodward remarked that, in the aftermath of the war, border controls are likely to be strengthened, which would not foster regional cooperation. Likewise, Veton Surroi, a leading journalist in Pristina and a leader of the Albanian Kosovars, forecasts a dynamic of links in the region which would favor “bilateral and trilateral ties” – following the consequences of the latest war.

<sup>8</sup> Spyros Voyadzis stated clearly that the sums assigned by the IMF and WB to the region came from other uses, which means that those were diverted. One can hardly escape the feeling that potential recipients in the rest of the world will put increasing pressure on the IFOs to do the same.



presence, tensions remain high and borders are still questioned. This means that future conflicts cannot be and should not be discounted.

A piece of good news is that the EU seems to have realized that neglect of the region and its economic sinking means Europe “playing with fire”. The Stability Pact and the pledges of financial assistance, of support in order to develop institutions that foster economic development and democracy, may provide the critical edge to start distancing the region from abyss.

High hopes should be, nonetheless, kept in check; for actual and sustained progress to take roots there is need of vision, stamina, patience, on the side of both local leaders and external actors. One needs to take into account the collective psychology of the peoples in the region, their suffering, pride, and time needed for healing of injuries. The “road to light” is long and arduous but worthwhile trying.